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Linkages, Access to Finance and the Performance of Small-Scale Enterprises in Kenya

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Abstract

Micro- and small-scale enterprises (MSEs) have become important players in the Kenyan economy, but at the same time they continue to face constraints that limit their development. Lack of access to financial services is one of the main constraints, and a number of factors have been identified to explain this problem. These include the segmented and incomplete nature of financial markets, which increases transaction costs associated with financial services. On the supply side, most formal financial institutions consider MSEs uncreditworthy, thus denying them credit. Lack of access to financial resources has been seen as one of the reasons for the slow growth of firms. Literature from the new institutional economics, however, shows that institutional arrangements, like linkages and networks between firms, provide an important avenue through which firms can overcome some of these constraints. Therefore, the question that arises is:

../.

Keywords: linkages, finance, enterprise performance

JEL classification: L2, L25

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how can such institutional arrangements contribute to the development of small-scale enterprises? This paper explores whether networks and linkages between the MSEs and financial institutions affect their access to financial services and performance. Using primary data collected from a sample of small-scale enterprises in two urban centres of Kenya, the paper analyses the nature of linkages between MSEs and financial institutions as well as the networks existing among MSEs, and the effect they have on enterprise performance. The results show that small-scale enterprises have different, albeit limited, forms of networks among themselves, and linkages with financial institutions. Some of these linkages have advantages, which are reflected in the firms' performance. The paper concludes that there is need for policy to strengthen the institutional networks among MSEs, to enable these access resources to overcome some of the constraints they face.

Acronyms

MFIs micro-finance institutions

MSEs micro- and small-scale enterprises

NIE new institutional economics

ROSCAs rotating savings and credit associations

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1 Introduction

This paper is motivated by the increasing importance in Kenya's economy of micro- and small-scale enterprises (MSEs), and the continuing constraints they face in their activities. The paper examines whether linkages between MSEs and financial institutions affect the enterprises' ability to access financial services and their performance. The development of MSEs has been identified as one of the strategies for generating industrialization, employment generation and poverty reduction in Kenya. This objective has been outlined in Kenya's major policy documents such as the Sessional Paper Number 2 of 1996 on Industrial Transformation to the year 2020, and Sessional Paper Number 2 of 2005 on the Development of MSEs for Employment and Wealth Creation (Republic of Kenya 1996, 2005). Despite recognition at the policy level, the sector faces constraints that limit its economic contribution. This paper applies the new institutional economics (NIE) approach to explore the issue of whether and how linkages among the MSEs as well as with the financial institutions affect the performance of these enterprises.

Lack of access to financial services is one of the main problems facing MSEs in Kenya. This has been attributed to a number of factors. Conceptually, the nature of credit markets, which are segmented and incomplete, is one explanation. Market segmentation implies that the demand for, and supply of, financial services do not interact. Due to the risky and intertemporal nature of credit trade, information requirements and enforcement problems for lenders are high, resulting in agency costs that affect the outcome of credit programmes targeted towards the MSEs. As a result, firms may prefer funds from external sources but fail to apply because of the high costs involved. While the overall financial market involvement of firms may be limited, smaller businesses have much less involvement than the larger ones (Bigsten et al. 2000). On the supply side, most formal financial institutions consider MSEs uncreditworthy due to their lack of growth potential and small size of activities.

The slow growth of firms, in turn, has been attributed by some researchers to the lack of access to financial resources (Nkurunziza 2005). Access to external resources is needed to ensure flexibility in resource allocation and reduce the impact of cash flow problems (Bigsten et al. 2000). Firms with access to funding are able to build up inventories to avoid stocking out during crises, while the availability of credit increases the growth potential of the surviving firms during periods of macroeconomic instability. Firms without access to bank funding are more vulnerable to external shocks (Nkurunziza 2005). Thus, the lack of access to credit remains a major constraint for the entrepreneurs in African countries.

Credit also enables individuals to smooth out consumption in the face of varying incomes, provides income for investment and improves ability to cope with unexpected expenditure shocks. But lack of collateral and the high possibility of default can prevent individuals from obtaining credit (Adams and Fitchett 1992; Besley 1995). Most literature on microfinance suggests that nonmarket institutions can play an important role in dealing with credit market imperfections (Okten and Osili 2004). Yet, the role of social networks in enhancing access to credit is less well understood.

Literature from NIE shows that linkages provide an important avenue through which firms can overcome some of their constraints, and to achieve goals that otherwise would have been unattainable. Such goals may include better access to information, product

markets, or financial services. Networks, such as associations, serve as cushions and thus enable enterprises to access different services. However, empirical evidence has shown that MSEs, because of weak interaction with each other, fail to reap the benefits from interfirm linkages, including access to support services like finance (Okech, Mitullah and Atieno 2002). The question, therefore, is: how can these linkages contribute to the development of small-scale enterprises by improving their access to financial services.

The paper uses primary data collected from a sample of small-scale clothing enterprises in two urban centres of Kenya, Eldoret and Kisumu, to analyse the nature of linkages between MSEs and financial institutions, as well as the networks among the MSEs and their effect on enterprise performance. The data were collected through a survey of 322 sampled micro- and small-scale enterprises in the clothing and textiles sector. Key informant interviews, based on 162 enterprises in Kisumu and 160 in Eldoret, were conducted during October and November 2006 with a structured questionnaire. The sample consisted of producers and traders as the main categories in the subsector.

The rest of the paper is organized as follows: section 2 gives a review of relevant literature on the role of networks in firm development. Section 3 presents the empirical results on enterprise characteristics and networks. Section 4 outlines the results of the relationship between enterprise linkages and performance while section 5 summarizes the conclusions.

2 Literature review

2.1 Linkages and enterprise development

Institutions have been defined as a set of rules governing behavioural relations among individuals and groups (Nabli and Nugent 1989). Institutions are predictable, understood as either formal or informal entities such as labour unions, markets, contracts, as well as cultural rules and codes of conduct (Nabli and Nugent 1989). The importance of institutions derives from the fact that economic action is embedded in a social context (Granovetter 1985). Hence an entrepreneur, being a socially embedded individual, will use his personal networks for the benefit of the enterprise. The status of the person within a network and the power associated with that position will determine what benefits will accrue to the enterprise. Relationship networks shape the form of the ensuing market exchange. Market entry, due to the externalities generated by the networks, is easier for network members than for non-members (Fafchamps 1999).

Linkages can be perceived as either a part of a wider network of social relationships, or more specifically as interaction between individuals and organizations (McCormick and Atieno 2002). Linkages can be classified into contracts, collaborations, contacts, and associations. This study, with its emphasis mainly on economic relationships, focuses on linkages between firms rather than linkages constituting a wider network of social relations. Both theoretical and empirical evidence suggests that specific social relations are among the factors that affect economic activities (Granovetter 1985; Whitley 1992).

Linkages affect firm performance in various ways. Barr (1998), using data from manufacturing firms in Ghana, identifies common patterns that link types of enterprises

and networks as well as their structure and effect. He concludes that networks impact on enterprise performance through various channels and to a different extent, depending on the function these networks perform. Entrepreneurs of larger enterprises tend to maintain large, diverse and less cohesive innovation networks, which are better suited to the provision of information on technology and markets. Smaller enterprises tend to maintain small homogeneous and cohesive networks aimed at reducing information asymmetries and thus supporting informal credit and risk-sharing arrangements. The paper further concludes that while the smaller solidarity networks may have a marginal effect on enterprise productivity, the major, significant impact is derived from innovation networks.

Associations are one major form of institutional networks. Firms join associations for a number of reasons, one of which is the building of social capital in order to establish contacts that may help them in the future. The size of the association is important in identifying the benefits to its members. Barr (1998) notes that smaller businesses tend to adhere to smaller networks while larger businesses favour large networks. Small networks, typical of small-scale enterprises, are often motivated by the desire to reduce risks while those by large businesses aim at enhancing business performance. The nature and relative importance of private or spillover effects also vary between small and large networks. Small networks tend to generate significant positive spillovers because within these networks, it is difficult to exclude individuals from mutual benefits. Large networks, common among large enterprises, tend to generate high private returns (Barr 1998).

Research on business systems (Okech, Mitullah and Atieno 2002) shows that while linkages do provide advantages, firms with limited resources, such as SMEs, may also be discouraged from joining or establishing contact because of the associated costs. This limits the extent to which small businesses can influence the support mechanisms such as policies, legislations and infrastructure that affect their operations. Small firms, therefore, face a number of constraints that are institutional in nature, but their weak organizational ability and the minimal or non-existent linkages limit the extent to which they can address these issues. Literature further shows that while clustering is common, well-developed interrelation networks are rare among enterprises. Yet, regardless of the dominance of clustering, the greatest contribution to enterprise competitiveness is made by networks and mutual action. Highly developed inter-firm division of labour, including subcontracting and technical innovation resulting from information flows, is observed only in the advanced clusters of South East Asia and Latin America (Barr 1998).

2.2 Networks and uncertainty

Interrelation networks can enhance the performance of manufacturing enterprises by improving their income-generating ability and capacity to compete. In addition, they can also help reduce the uncertainties faced by enterprises, by providing entrepreneurs with information on various aspects such as markets and technology. Information on output markets, their functions and standards, may help enterprises become more competitive, and thus have a direct effect on productivity (Barr 1998). A network that reduces uncertainty may increase performance indirectly by encouraging higher levels of investments. It is argued that the relative importance of the two functions to an

entrepreneur will determine the kind of network he will maintain, and the effect of these networks on its performance.

In most African countries, uncertainties are caused by poor contract discipline, resulting from poverty and unanticipated difficulties arising from shortage of inputs, delayed payments and transportation problems. However, information asymmetry and the associated high transaction costs make it difficult for entrepreneurs to identify poor contract enforcement that results from such difficulties as opposed to those resulting from incompetence. Thus, to reduce information asymmetry, entrepreneurs in most African countries rely on networks to facilitate information flows, and provide a basis for credit, trade and insurance. Networks also affect individual access to credit sources (Okten and Osili 2004). Networks can provide information about credit sources, thus lowering transaction costs, and individuals with strong family and community networks will have greater access to credit because of the advantage of their informative links.

Despite the importance of credit in the uncertain environment evident in most of Africa, credit markets are seriously affected by poor contract discipline and information asymmetries. Different institutional environments exist for different types of enterprises: formal credit is available for those with collateral, and who operate in an environment with well-defined property rights. At the same time, there is informal credit for those who lack property rights, but who are supported by informal networks. Networks, therefore, can become a substitute for the institutions that support the formal market. Although larger informal credit arrangements and risk-sharing are more efficient, for a certain size of business, the cost of acquiring information may outweigh the benefits. Expanding network diversity also increases the cost of acquiring information. As a result, sharing arrangements are likely to be limited to people with broadly similar abilities, character and prospects. Different networks perform diverse functions, and an uncertainty-reducing network will enhance enterprise performance indirectly, through increased investments, and informal credit for overcoming capital constraints.

Fafchamps (1999) argues that transaction costs induce market participants to enter into long-term trading relationships that shape market outcomes. He identifies two types of institutions that have arisen to minimize transactions costs: relationships and the sharing of information through networks. Market entry, due to network externalities, is likely to be easier for network members than nonmembers. Networks tend to steer potential investors towards sectors that have benefits derived through network externalities.

2.3 Why firms form linkages

Firms form links in order to attain objectives they could not achieve alone. Linking enables firms to overcome some of their constraints like the lack of finance, access to raw materials, market information, and inputs or technology. Small firms are constrained mostly by the lack of working and investment capital, hence many firms form linkages and relations for the specific purposes of acquiring finance and other services. Linkage between firms can ease such constraints by reducing the required amount of fixed capital while vertical linkages between producers and suppliers may bring credit to ease working capital requirements. Linkages may also provide access to new sources of capital, through membership in group-lending schemes, where micro enterprises join together to guarantee loans for each other. Small firms may also link with larger businesses to take advantage of important firm-survival techniques: superior

management capability, technology, market information, and finance (Meyanathan and Munter 1994). In this study, linkages are perceived as relations between individuals or organizations, with firms as the main actors.

Linkages offer a number of potential benefits to firms: helping to improve firm performance by reducing marketing costs, increasing firm flexibility, improving skills and their diffusion, as well as facilitating information-sharing (McCormick and Atieno 2002). Linkages, in the form of network, also help to reduce the uncertainties faced by enterprises. Despite these potential benefits, existing evidence shows that compared to large firms, most MSEs do not belong to any type of business support group and have limited interaction with firms that are bigger than their own. Participation in associations that could offer benefits to its members is also limited (CBS, K-REP and ICEG 1999; Okech, Mitullah and Atieno 2002). The paucity of linkages among the MSEs hamper their flexibility to take up emerging entrepreneurial opportunities which, in turn, contributes to inadequate technological transfers, poor information flow, weak subcontracting arrangements, and inadequate marketing opportunities. The main line of discussion in this paper is thus identifying the different types of linkages that exist between enterprises and their associated benefits for the enterprises. We consider the different types of linkages, namely informal groupings, associations, subcontracting, and linkages between MSEs and financial institutions.

3 Empirical analysis

This section presents the empirical results. We start with a brief description of the main characteristics of the sampled clothing enterprises. Different forms of linkages between firms are expected to bring different types of advantages to the enterprises. Linkages existing among the enterprises themselves as well as those that exist between the enterprises and the financial institutions are also identified and discussed.

3.1 Enterprise characteristics

In this section, we review the main characteristics of the enterprises: firm history, ownership, size and sources of finance. These characteristics are important in determining the development of firm linkages and their contribution to enterprise performance. The nature of linkages and their benefits to firms, for example, are likely to differ according to firm size.[1] Studies show that large firms are more likely to receive more loans, have higher indebtedness, rely less on informal loans, and have better access to credit than small firms, the majority of which get their loans from informal financing sources (Bigsten et al. 2000). Firms also have different types of linkages: large firms, as opposed to small businesses, are more likely to have extended networks that provide information on markets and technology (Barr 1998). Firm ownership is also noted to be important in accessing financial services. Many MSEs are owned by Kenyans, but the share of African-owned enterprises falls sharply when moving up the scale of enterprise size; ownership by individuals of Asian origin is common among the

[1] The definition of firm size used here is based on the GEMINI definition: firms with 1-10 employees are considered small, those with 11-49 as medium, and those with over 50 as large. See also McCormick and Atieno (2002).

medium- and large-scale firms. More established firms are also more likely to have stronger networks than the new entrants (Ikiara et al. 2002; Okech, Mitullah and Atieno 2002).

From our sample, most enterprises had been started by individuals on their own; the highest number of owners per enterprise was three. The mean enterprise age was 8.6 years, and the data further show that 71.7 per cent of the enterprises had been in existence less than eleven years old, implying that they had been set up after 1994. This conforms with the observation that Kenya's informal sector experienced its most rapid growth in the 1990s, a period when the formal sector also faced a major downturn, resulting from the declining economic performance during the 1990s.

In terms of gender of the entrepreneurs, a slight majority of the new entrants were females (50.3 per cent; males, 49.7 per cent). A national survey of MSEs (CBS, K-REP and ICEG 1999) showed that men owned 52 per cent of the enterprises, women 48 per cent. The educational attainment of these entrepreneurs ranged from those with no education to those with university education. Most entrepreneurs, however, had achieved secondary education level, supplemented with training. This may imply that most people with this level of education failed to find employment in the formal sector, and thus resorted to MSE activities.

Although sources of finance for enterprise start-up varied from own savings, retirement benefits to gifts from relatives, the majority (56.8 per cent) had started the business with capital from savings at home, and there were no cases of bank loans for enterprise start-ups. It is also noteworthy that only 2 per cent of the enterprises were started with supplier credit, signifying few networks with financial institutions. Results from other studies show that trade credit was less likely to be used by Kenya's small manufacturing firms compared to the large firms, most of whom had the option of utilizing trade credit (Isaksson and Wihlborg 2002). Bigsten et al. (2000) also find that large firms have more bank overdrafts than small firms. The MSEs, therefore, appear to be lacking support services, especially from the financial sector.

In determining the linkages and access to services like finance as well as enterprise performance, ownership and size are important characteristics. Enterprise ownership is associated with the firm's ability to mobilize financial resources (Ikiara et al. 2002). In connection with their study of African manufacturing firms, Bigsten et al. (2000) observe that even though general financial market involvement in the form of borrowing is limited, there are differences across firm sizes, with large firms receiving more loans and having higher indebtedness than small firms. Furthermore, manufacturing firms are noted to have different levels of productivity, depending on their size (Söderbom 2001). We find that 59 per cent of the firms in our sample had no employees. The type of linkages an enterprise can establish depends on ownership.

This study shows that women owned 50.3 per cent of all the enterprises in the sample, including firms that are both in singular or multiple ownership. Since most enterprises were individually owned, women therefore had ownership in half of the enterprises. This gender distribution compares with the results of the 1999 national survey where 55.7 per cent of the MSEs in trade were female owned. There are different ways of measuring firm size, but is considered here in terms of the number of employees.

3.2 Linkages among the enterprises

The data collected from the survey contained information on the linkages among MSEs, including their operating environment as well as enterprise networks. The questions on networks included the nature and number of contacts they maintained with different types of the enterprises. These concerned linkages with enterprises of various size and activities, linkages with other enterprises in the same line of business, or different lines of business, with smaller or larger enterprises, linkages with financial institutions as well as membership to networks. This information was used to capture the networking activity of the enterprises.

The information on the enterprises' institutional environment was collected in terms of whether or not they used formal sources of credit and other financial services. The indicator of potential market diversity used here relates to the enterprises' market outlets and users of their products, with small-scale enterprises more likely to supply only end-users. Enterprises were also asked whether they sold their products directly to consumers, to wholesalers or through brokers.

Like Barr (1998), we argue that in production, small enterprises employ relatively labour-intensive technologies and their employees are significantly less educated and experienced. Small enterprises, with these characteristics, have less to gain and more to lose from large, diverse networks. Instead, they are likely to build relatively small, homogeneous and cohesive solidarity networks that can substitute for the formal market-supporting institutions and help them cope with potential information asymmetries. Larger enterprises, on the other hand, have reasonable access to formal institutions and may thus have more to gain from large, diverse innovation networks. The enterprise linkages are presented in Table 1.

Table 1
Enterprise network characteristics

Network description	Percentage of respondents	Standard deviation
Institutional environment		
Enterprises having applied for bank loan/overdraft	34.8	0.47702
Enterprises having interactions with formal financial institutions	41.6	0.49369
Enterprises having savings with formal financial institutions	78.0	0.41523
Market diversity		
Enterprises supplying end users (final consumers) only	83.5	0.68844
Networks		
Contacts with other enterprises	73.0	0.44475
Contacts approached during crisis	66.5	32.8325
Membership to associations with enterprises in same kind of activity	23.6	0.42530
Membership to associations with enterprises in different kinds of activity	33.2	0.47177
Membership to informal groupings	53.7	0.49939
Number of enterprises	322	

Groupings and interactions among the enterprises

The enterprises were classified according to the different forms of interaction among firms, such as memberships with welfare groups among the entrepreneurs as well as informal groupings. People join groups to initiate contacts that may not offer immediate benefits but which may become useful later, through either formal or informal networks (McCormick, Mitullah and Kinyanjui 2003). Business groupings or associations were the main form of MSE interaction; 73 per cent of the enterprises had relationships with other enterprises operating either in similar or dissimilar business fields, while 27 per cent had no relationships at all.

Subcontracting

Subcontracting arrangements belong to a broader category of contractual linkages. Typical motives include reduction of labour costs, risk-minimizing through lowered fixed costs, the need for specialized products that would be difficult to produce in-house, as well as the desire to keep the business small.

Subcontracts can be either received or extended by enterprises. Subcontracts had been received by only 45.3 per cent of the enterprises; no subcontract offers had been made to more than half of the sample firms. Fear of the inability to meet subcontract targets, inadequate capacity and/or inadequate finances to undertake subcontracting, difficulty of obtaining subcontracts, being new in the business, and no interest in subcontracts were the reasons cited. Among those working with subcontracts, most subcontracts had originated from similar-sized firms in the same business line (Table 2).

Subcontracts can be categorized into specialized or seasonal subcontracts, as well as those arising from inadequate capacity. Specialized subcontracting was the main type (utilized by 18 per cent of the firms), followed by seasonal subcontracting (15.5 per cent), while subcontracts to supplement inadequate capacity accounted for 11.8 per cent.

Also, most enterprises did not issue subcontracts; this option was used only by 47.5 per cent of the enterprises. Having adequate capacity was the most common reason (24.2 per cent) for not considering subcontracts. Other reasons included lack of interest, the need to be independent, and fear that subcontracted firms would fail to meet their obligations. Among those utilizing subcontracts, most enterprises preferred similar-sized firms in the same line of business (Table 3). Most enterprises (25.2 per cent) selected subcontracting to supplement inadequate capacity.

Table 2
Characteristics of sources of subcontracts by enterprise size

Source of subcontracts	Frequency	Percentage
Same sized enterprise, same business line	83	25.8
Large firms, same business line	20	6.2
Large firms, different business line	14	4.3
Smaller firms, different business line	13	4.0
Smaller firms, same business line	12	3.7
Same size, different business line	4	1.2
No subcontracts	176	54.7
Total	322	100.0

Source: Computed from survey data.

Table 3
Characteristics of enterprises given subcontracts by firm size

Firms receiving subcontracts	Frequency	Percentage
Large firms same business line	6	1.9
Large firms different business line	4	1.2
Same size same business line	98	30.4
Same size different business line	42	13
Smaller firms same business line	3	0.9
Smaller firms different business line	0	00
Not giving out a subcontract	169	52.5
Total	322	100

Source: Computed from survey data.

The entrepreneurs, therefore, seem to interact more with firms in a similar line of activity and size. This may be a factor that limits the amount of resources they can pool together if resource-constrained. It has been argued that the concentration of African entrepreneurs to MSEs is the result of their inability to mobilize financial resources that could enable them to expand and exit MSE activities (Ikiara et al. 2002).

Associations

Business associations have been defined as collective bodies that serve as intermediaries between individual businesses and the state. Thus, they are organizations that may influence the development of individual businesses. Associations perform functions that could have a facilitating role on the development of networks among MSEs (Bennett 1998). Associations are established for various reasons, a fact which can affect their effectiveness. While some focus specifically on the business activities of their members, others do not have business as their primary focus (McCormick, Mitullah and Kinyanjui 2003). Associations provide benefits for their members, yet only 23.6 per cent of the enterprises from the sample belonged to an association comprising of enterprises in similar lines of activity. Thirty-three per cent belonged to enterprise associations not related to their business line. Inability to meet the association's financial requirements was a major cause of non-membership.

Associations had been formed to serve various interests and thus existed for different purposes. These included the provision of credit to members, helping with welfare matters or development of business. Some enterprise owners belonged to several associations if one association did not meet all their needs. The multiple association membership can be explained by the fact that associations are mostly created by individuals with similar criteria, i.e., traders in a specific commodity, or even people from the same clan, implying that an individual can belong to several entities in order to satisfy different needs.

3.3 Linkages between MSEs and financial institutions

In this section, we present the results of the linkages between enterprises and financial institutions. One of the constraints often identified with MSEs is the lack of finance. Over half (58 per cent) of the respondents indicated that they had no interaction with financial institutions because of the high transaction costs associated with these services, their repayment procedures, and the institutional recovery methods in case of

default. There are, however, different types of linkages between the enterprises and financial institutions.

Linkages with commercial banks

The main form of interaction between MSEs and commercial banks was the enterprises' use of savings services. Most traders had savings accounts with commercial banks. Group savings were also held mostly with commercial banks. In addition to savings, loans were the other main service utilized by enterprises. However, only 34.8 per cent reported having ever applied directly for credit. In contrast to the low number of borrowers, the majority (78 per cent) saved a part of their earnings with financial institutions, with 55 per cent depositing with commercial banks while others favoured self-help groups, micro-finance institutions (MFIs) and rotating savings and credit associations (ROSCAs). Small-scale enterprises mobilize savings through commercial banks, but such savings may not come back to them in the form of credit.

When credit application is examined from the perspective of network membership in associations or informal groupings, we notice that most of the entrepreneurs who had applied for credit were association members while the majority of the non-members made no effort to seek credit (Table 4). Informal group members and those not affiliated with any group had also refrained from applying for credit.

Table 4
Credit applications, based on network membership

Entrepreneur	Had applied for loan before	Never applied for loan before
Belongs to association(s)	55.3	44.7
Does not belong to any association	28.5	71.5
Belongs to informal grouping(s)	36.4	63.6
Does not belong to any informal grouping	32.9	67.1
Total	34.8	65.2

Linkages with MFIs

Microfinance refers to the practice of providing financial services, such as micro-credit, micro-savings or micro-insurance to poor people, to help them to accumulate larger sums of money, thus expanding their choices and reducing their risks. Institutions providing these services are referred to as micro-finance institutions (MFIs). Linkages with MFIs are the main avenue through which the MSEs access financial services. Services to the MSEs include the provision of savings and loans through groups, cheque clearance services, client training on business management, insurance services, as well as provision of assets (for instance, heifers). MSEs interact with the MFIs mainly through loans operations that are provided mostly through groups. The groups, the main channel through which loans are extended, are formed according to the specifications of each respective MFI. In most cases, groups need to accumulate certain level of savings before they are eligible for MFI loans. The savings mobilized by the group is the security for loans taken by members.

Various benefits are derived through enterprise interaction with financial institutions. Accessing credit for their businesses was one such major advantage. Others included business training, a secure and accessible savings facility, and cash transfer services.

Sixty-one per cent of the enterprises also belonged to other groups, such as the ROSCAs, merry go-rounds, women groups, and welfare associations, which enabled them to access financial resources. Such groups provided not just funding but also other services, like health insurance for members, training, and assistance in welfare matters which might have affected their business, like cases of deaths. These services indirectly benefit the business by enabling entrepreneurs to refrain from having to divert resources from the business.

4 Linkages and enterprise performance

One of the main reasons why firms form linkages is the ultimate improvement of their performance. Firm performance can be measured with different indicators, such profitability, growth in employment, production level, or even sales. In addition, firms also have their own performance indicators (Meyanathan and Munter 1994; McCormick and Atieno 2002; Okech, Mitullah and Atieno 2002). However, all these indicators have both advantages and disadvantages. The profitability measure, for example, is problematic that most small firms do not keep records, nor share income information readily. On the other hand, some firms may opt not to expand, preferring to diversify into other activities to minimize risks. In this study, we use firm performance based on specific indicators that incorporate both the enterprises' own performance measures as well as the conventional measures. Following the literature, it is hypothesized that the different forms of linkages have a positive effect on firm performance. Firms with more linkages would therefore be expected to experience a better performance than those lacking all linkages.

In this section, based on the hypothesis that linkages improve firm performance, we analyse the performance of the enterprises in relation to the different kinds of linkages. Using selected indicators, we compare the enterprises with various linkages against those without similar relationships. The results show that the differences in production volume are significant between firms favouring relationships compared to those which do not. Also, the difference in all indicators between enterprises belonging to associations of similarly-oriented firms and those not in such associations is significant (Table 5).

Table 5
Comparison of selected indicators for firms belonging/not belonging to associations of similarly-oriented enterprises

		Mean value		
Indicator		In associations (n=76)	Not in associations (n=246)	t-value
Production volume at:	present	166.58	63.93	6.132***
	start-up	87.46	56.25	2.818***
Temporary employment at:	present	8	1	2.375**
	start-up	1	0	3.127***
Sales volume at:	present	16172.14	7050.35	3.443***
	start-up	4983.00	3010.98	1.819*
Profit level now:	present	5164.87	1953.89	3.746***
	start-up	2039.50	983.28	2.987***

Note: *** significant at 1%; ** significant at 5%; * significant at 10%.

Table 6
Comparison of selected indicators for firms interacting/not interacting with financial institutions

Indicators		Mean value: With interaction (n=134)	Mean value: Without interaction (n=188)	t-value
Production volume at:	present	110.67	72.11	2.556**
	start-up	66.87	61.30	0.577
Temporary employment at:	present	5	1	1.538
	start-up	1	0	1.679*
Sales volume at:	present	10727.65	8116.84	1.126
	start-up	3509.44	3452.90	0.063
Profit level now:	present	3482.65	2162.29	1.758*
	start-up	1231.71	1233.19	0.050

Note: ** significant at 5%; * significant at 10%.

Table 7
Comparison of selected indicators for enterprises saving/not saving with financial institutions

Indicators		Mean value: Those saving (n=251)	Mean value: Those not saving (n=71)	t-value
Production volume at:	present	96.3	59.4	3.388***
	start-up	63.2	65.1	0.206
Temporary employment at:	present	3	1	1.558
	start-up	1	1	1.062
Sales volume at:	present	10,004.6	6,370.7	1.470
	start-up	3,099.4	4,809.2	1.098
Profit level now:	present	3,180.3	1,055.3	4.008***
	start-up	1,166.8	1,465.1	0.586

Note: *** significant at 1%; ** significant at 5%; * significant at 10%.

Firms interacting with financial institutions are noted to have significantly better profits, greater production volumes, and higher initial temporary employment than those businesses without such interaction (Table 6). However, when we look at these differences for producers and traders separately, we see that for producers the only difference is current production volumes, and on the part of traders, temporary employment numbers. We also investigate the significance of differences in these indicators for enterprises interacting with financial institutions and those that do not. The results (Table 7) show that significantly higher production volumes and profit levels are exhibited by the firms with financial institution support than those without. Within this operating framework of associations, savings act as security for loans either from associations or the MFIs. Key informant interviews also indicate that although clothing enterprises as a group do not borrow from commercial banks, some do so individually in cases where their businesses can provide adequate collateral.

The results seem to indicate that although some linkages can contribute to better business performance, this is not always the case. The nature of the linkages is important: membership in associations and interaction with financial institutions in the form of savings are significant for enterprise performance. Associations are formed for various objectives, such as mobilization of financial resources and provision of credit to members as well as addressing social welfare issues that could affect the business of a

member. Indirectly, this ensures that there is no deviation of financial resources from the enterprises that could affect its performance. Also, it would appear that interaction with similarly-oriented firms is more relevant than interaction with those in different lines of business.

Interaction with financial institutions implies access to external sources of finance, which can increase the flexibility of the firm to allocate resources and to take up emerging investment opportunities as well as reduce cash flow problems. Entrepreneurs form groups either to directly facilitate access to business credit or to address non-business problems that affect their operations. As most MFIs provide credit to enterprises only through associations or groupings, these linkages are likely to improve financial flexibility.

5 Conclusions

This paper, using primary data collected in two urban centres of Kenya, has investigated the nature of linkages between MSEs and financial institutions and how these impact on enterprise performance.

The results show that small-scale enterprises have different, albeit limited, forms of linkages both among themselves, and with financial institutions. Such linkages include associations that help to mobilize and allocate financial resources among its members, informal groupings, and savings interactions with financial institutions. Linkages with financial institutions are evident as loans, mainly with MFIs, while interaction with commercial banks is limited to savings services only. Despite the limited linkages, the results show that some linkages provide advantages to the enterprises which are reflected in their performance. Evidence from other studies (Okech, Mitullah and Atieno 2002; Ikiara et al. 2002) may help to support the observation here that firms belonging to associations achieve better performance than those without. This is because associations help members access certain services which can help to improve their performance, such information, finance and support on social issues that may affect their business performance.

Some conclusions can be drawn from these results. The small-scale enterprise sector is a vibrant, providing employment both directly to those involved in it, and also through links such as the development of other enterprises, which provide other services to the section. Linkages between the enterprises themselves and with financial institutions enable these to access financial services. Financial services contribute directly either to the development of the business by injecting external funding or by addressing social problems that could affect its financial stability and hence performance. Membership to association networks appears to be important in facilitating access to financial services.

Institutions, such as associations, which support the MSEs's capacity to access financial services are an important avenue for strengthening MSEs. Sessional Paper Number Two of 2005 on the Development of Micro- and Small-Scale Enterprises for Wealth and Employment Creation for Poverty Reduction, recognizes the need for investment incentives that enhance the development of linkages between MSEs and large enterprises. This recognition needs now to be moved to the level of implementation. Results from this study show that access to financial services through various linkages

is important for the clothing enterprises. The capacity of the different types of financial institutions through which MSEs obtain financial services needs to be strengthened to enable them to improve their services. Establishing the proposed Micro Finance Trust Fund from which MFIs can withdraw for on-lending to the MSEs is an important step in increasing their capacity, while at the same time, it would provide a regulatory framework to guide MFI activities. Enactment of the microfinance bill is therefore important.

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